

(A) Is materially modified so that it no longer satisfies the definition of straight debt; or

(B) Is transferred to a third party who is not an eligible shareholder under paragraph (b)(1) of this section.

(iv) *Treatment of straight debt for other purposes.* An obligation of an S corporation that satisfies the definition of straight debt in paragraph (1)(5)(i) of this section is not treated as a second class of stock even if it is considered equity under general principles of Federal tax law. Such an obligation is generally treated as debt and when so treated is subject to the applicable rules governing indebtedness for other purposes of the Code. Accordingly, interest paid or accrued with respect to a straight debt obligation is generally treated as interest by the corporation and the recipient and does not constitute a distribution to which section 1368 applies. However, if a straight debt obligation bears a rate of interest that is unreasonably high, an appropriate portion of the interest may be recharacterized and treated as a payment that is not interest. Such a recharacterization does not result in a second class of stock.

(v) *Treatment of C corporation debt upon conversion to S status.* If a C corporation has outstanding an obligation that satisfies the definition of straight debt in paragraph (1)(5)(i) of this section, but that is considered equity under general principles of Federal tax law, the obligation is not treated as a second class of stock for purposes of this section if the C corporation converts to S status. In addition, the conversion from C corporation status to S corporation status is not treated as an exchange of debt for stock with respect to such an instrument.

(6) *Inadvertent terminations.* See section 1362(f) and the regulations thereunder for rules relating to inadvertent terminations in cases where the one class of stock requirement has been inadvertently breached.

(7) *Effective date.* Section 1.1361-1(l) generally applies to taxable years of a corporation beginning on or after May 28, 1992. However, § 1.1361-1(l) does not apply to: an instrument, obligation, or arrangement issued or entered into before May 28, 1992, and not materially

modified after that date; a buy-sell agreement, redemption agreement, or agreement restricting transferability entered into before May 28, 1992, and not materially modified after that date; or a call option or similar instrument issued before May 28, 1992, and not materially modified after that date. In addition, a corporation and its shareholders may apply this § 1.1361-1(l) to prior taxable years.

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**§ 1.1361-2 Definitions relating to S corporation subsidiaries.**

(a) *In general.* The term *qualified subchapter S subsidiary* (QSub) means any domestic corporation that is not an ineligible corporation (as defined in section 1361(b)(2) and the regulations thereunder), if—

(1) 100 percent of the stock of such corporation is held by an S corporation; and

(2) The S corporation properly elects to treat the subsidiary as a QSub under § 1.1361-3.

(b) *Stock treated as held by S corporation.* For purposes of satisfying the 100 percent stock ownership requirement in section 1361(b)(3)(B)(i) and paragraph (a)(1) of this section—

(1) Stock of a corporation is treated as held by an S corporation if the S corporation is the owner of that stock for Federal income tax purposes; and

(2) Any outstanding instruments, obligations, or arrangements of the corporation which would not be considered stock for purposes of section 1361(b)(1)(D) if the corporation were an S corporation are not treated as outstanding stock of the QSub.

(c) *Straight debt safe harbor.* Section 1.1361-1(l)(5)(iv) and (v) apply to an obligation of a corporation for which a QSub election is made if that obligation would satisfy the definition of straight debt in § 1.1361-1(l)(5) if issued by the S corporation.

(d) *Examples.* The following examples illustrate the application of this section:

*Example 1.* X, an S corporation, owns 100 percent of Y, a corporation for which a valid QSub election is in effect for the taxable year. Y owns 100 percent of Z, a corporation otherwise eligible for QSub status. X may elect to treat Z as a QSub under section 1361(b)(3)(B)(ii).

*Example 2.* Assume the same facts as in *Example 1*, except that Y is a business entity that is disregarded as an entity separate from its owner under § 301.7701-2(c)(2) of this chapter. X may elect to treat Z as a QSub.

*Example 3.* Assume the same facts as in *Example 1*, except that Y owns 50 percent of Z, and X owns the other 50 percent. X may elect to treat Z as a QSub.

*Example 4.* Assume the same facts as in *Example 1*, except that Y is a C corporation. Although Y is a domestic corporation that is otherwise eligible to be a QSub, no QSub election has been made for Y. Thus, X is not treated as holding the stock of Z. Consequently, X may not elect to treat Z as a QSub.

*Example 5.* Individuals A and B own 100 percent of the stock of corporation X, an S corporation, and, except for C's interest (described below), X owns 100 percent of corporation Y, a C corporation. Individual C holds an instrument issued by Y that is considered to be equity under general principles of tax law but would satisfy the definition of straight debt under § 1.1361-1(l)(5) if Y were an S corporation. In determining whether X owns 100 percent of Y for purposes of making the QSub election, the instrument held by C is not considered outstanding stock. In addition, under § 1.1361-1(l)(5)(v), the QSub election is not treated as an exchange of debt for stock with respect to such instrument, and § 1.1361-1(l)(5)(iv) applies to determine the tax treatment of payments on the instrument while Y's QSub election is in effect.

[T.D. 8869, 65 FR 3849, Jan. 25, 2000]

### § 1.1361-3 QSub election.

(a) *Time and manner of making election*—(1) *In general.* The corporation for which the QSub election is made must meet all the requirements of section 1361(b)(3)(B) at the time the election is made and for all periods for which the election is to be effective.

(2) *Manner of making election.* Except as provided in section 1361(b)(3)(D) and § 1.1361-5(c) (five-year prohibition on re-election), an S corporation may elect to treat an eligible subsidiary as a QSub by filing a completed form to be prescribed by the IRS. The election form must be signed by a person authorized to sign the S corporation's return required to be filed under section

6037. Unless the election form provides otherwise, the election must be submitted to the service center where the subsidiary filed its most recent tax return (if applicable), and, if an S corporation forms a subsidiary and makes a valid QSub election (effective upon the date of the subsidiary's formation) for the subsidiary, the election should be submitted to the service center where the S corporation filed its most recent return.

(3) *Time of making election.* A QSub election may be made by the S corporation parent at any time during the taxable year.

(4) *Effective date of election.* A QSub election will be effective on the date specified on the election form or on the date the election form is filed if no date is specified. The effective date specified on the form cannot be more than two months and 15 days prior to the date of filing and cannot be more than 12 months after the date of filing. For this purpose, the definition of the term *month* found in § 1.1362-6(a)(2)(ii)(C) applies. If an election form specifies an effective date more than two months and 15 days prior to the date on which the election form is filed, it will be effective two months and 15 days prior to the date it is filed. If an election form specifies an effective date more than 12 months after the date on which the election is filed, it will be effective 12 months after the date it is filed.

(5) *Example.* The following example illustrates the application of paragraph (a)(4) of this section:

*Example.* X has been a calendar year S corporation engaged in a trade or business for several years. X acquires the stock of Y, a calendar year C corporation, on April 1, 2002. On August 10, 2002, X makes an election to treat Y as a QSub. Unless otherwise specified on the election form, the election will be effective as of August 10, 2002. If specified on the election form, the election may be effective on some other date that is not more than two months and 15 days prior to August 10, 2002, and not more than 12 months after August 10, 2002.

(6) *Extension of time for making a QSub election.* An extension of time to make a QSub election may be available under the procedures applicable under §§ 301.9100-1 and 301.9100-3 of this chapter.